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WASHINGTON, DC 20554

In the Matter of)
)
Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

COMMENTS OF
CITIZENS FOR A SOUND ECONOMY FOUNDATION

Citizens for a Sound Economy Foundation (CSE Foundation) submits this comment to assist the Commission in its fourth year review of the Local Exchange Carrier (LEC) price cap plan.

CSE Foundation is a nonpartisan, nonprofit 501(c)(3) educational institution. With over 250,000 members, CSE Foundation promotes initiatives that reduce government involvement in citizens' economic affairs. Toward this end, we view price cap regulation as superior to rate-of-return regulation on two counts:

1. Price cap regulation is less intrusive. By eliminating the LECs' incentives to pad the rate base, it permits LEC entry into competitive markets with a minimum of restrictions and complex safeguards.
2. Price cap regulation harnesses the creative, entrepreneurial energies of LECs to provide consumers with lower-cost, higher-quality telephone service.¹

¹See, generally, Comments of Citizens for a Sound Economy Foundation, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 (filed June 8, 1990).

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List A B C D E

In its Notice of Proposed Rulemaking, the Commission solicited comments on a wide variety of issues related to review, revision, and refinement of the price cap plan for LECs.² At this time, CSE Foundation will confine its comments to two types of issues: Those on which we offer a perspective that might not otherwise be heard in this Rulemaking, and those on which our perspective might differ substantially from that of other organizations concerned primarily with consumer interests.

As an organization directly supported by individual citizen members, we have an expansive definition of the consumer interest. We speak not for a particular industry, but rather on behalf of the general consumer interest -- what economists and some legal scholars have come to call "consumer welfare." Consumer welfare is maximized when every unit of every resource is employed in the use that consumers value most highly, and producers are actively searching for new ways to create more value for consumers at a lower cost.³ With these general thoughts in mind, we offer the following comments on specific issues:

"General Issue 2: What has been the effect of the price cap plan on consumer welfare, the economy, and the creation of jobs both in telecommunications and in other sectors of the economy..."⁴

At this time, CSE Foundation would like to emphasize several analytical points that the Commission should keep in mind as it evaluates studies and statistics on "job creation." It is tempting to juxtapose consumer welfare and job creation, as if what is good for the

²In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1 (January 19, 1994). Hereafter cited as "Notice of Proposed Rulemaking."

³See A. Kahn, The Economics of Regulation, Vol. I (1990), at 15-19; R. Posner, Economic Analysis of Law, 2d ed. (1977), at 1-14; R. Bork, The Antitrust Paradox (1978) at 107.

⁴Notice of Proposed Rulemaking, at 14.

LECs' customers is bad for the economy generally. The LECs, after all, may enhance efficiency by reducing the size of their workforces. Surely, some may argue, such actions destroy jobs; the displaced workers lose their jobs, and many in other industries lose their jobs as these workers' purchasing power is withdrawn from the economy.

The Commission should reject such arguments in all of their forms. The idea that lower telecommunications prices entail net job losses ignores the fact that lower telecommunications prices free up consumer purchasing power for expenditure on other goods and services. Job losses in telecommunications are thus balanced by expanded opportunities elsewhere in the economy. As the Notice of Proposed Rulemaking implies, these opportunities may crop up in the industries that use telecommunications services intensively, because lower telecommunications prices make these industries more profitable and hence encourage expansion.⁵ In addition, it is important to note that the new job opportunities may arise in sectors of the economy far distant from the LECs and their major customers. Job growth will occur wherever consumers opt to spend the money that they save on their telephone bills. Studies that concentrate solely on the telecommunications industry, or on the economic sectors that use telecommunications most heavily, thus systematically will understate the number of new job opportunities created as a result of price-cap-induced innovation and change.

Some may agree that this reasoning explains the impact of cost reductions when they translate into price reductions, but still insist that the LECs' increased profits act as a "drag" on this process. Profits, though, do not just pile up under a mattress; people receive profits.

⁵Id. at 14.

The millions of retirees with pension funds invested in LEC stocks are also consumers. The benefits of price caps that do not flow to LEC customers flow to stockholders, who either reinvest their profits or spend them. Either way, new jobs are created.

Finally, one must keep all of the rhetoric about "job creation" in proper perspective. No public policy enhances consumer welfare merely by creating jobs per se. Consumer welfare is enhanced when the people holding the jobs actually create goods and services that consumers value. Any policy that encourages firms to restructure so that consumers receive more value at a lower cost enhances consumer welfare. Therefore, even if some studies seem to show that price caps have reduced the number of jobs, our society is not worse off. Consumers are getting more telecommunications output, with a smaller expenditure of resources. The prospect of higher profits offered by price caps encourages LECs to find these benefits for consumers.

"Baseline Issue 3a: Whether the productivity factor used to compute the LEC price cap indices should be changed... whether a one-time change in the LEC's price cap index should be required...whether the Commission should adopt a mechanism which would adjust the plan to reflect changes in interest rates."⁶

Interest rates have fallen since the Commission instituted price caps. Since interest rates affect LEC profits proportionately more than they affect the price caps' inflation adjustment index, the Commission would like to know whether price caps should be adjusted in some way to reflect interest rate changes.

CSE Foundation believes that the Commission should resist the temptation to alter price caps in response to interest rate changes. It is true that such a change might seem

⁶Id. at 20.

"fair," since interest rates are beyond the LECs' control. However, the ways in which LECs respond to interest rates are within their control. For example, LECs must make decisions about the timing of investments and the term structure of debt. Adjusting price caps to reflect interest rate changes could undermine the LECs' incentives to make prudent decisions in these areas.

To see how, consider a LEC that is contemplating whether to undertake a new project in 1994 or wait a few years. If the LEC expects interest rates to rise, it can benefit both shareholders and consumers by initiating the project now and locking in a low, long-term interest rate. But if price caps will be adjusted for interest rates, the LEC will know it can raise prices in the future to cover higher interest rates. The prospect of this adjustment will tend to make the LEC indifferent between starting the project now and starting it later. Alternatively, the LEC might start the project now, but finance it with short-term debt, even though costs over the long run would be lower with long-term debt. In effect, adjusting price caps to reflect interest rate changes would move the LECs closer toward the old "cost plus" system of regulation. In so doing, the Commission would diminish their incentives to time investments and manage debt prudently.

"Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated."⁷

CSE Foundation believes that the sharing and low-end adjustment mechanisms should be eliminated, for two reasons. First, the Commission recognized that these mechanisms might diminish efficiency incentives. They were nevertheless adopted to compensate for

⁷Id. at 23.

possible errors in the choice of productivity targets.⁸ Now that the LECs have some experience with price caps, we can ask whether the original productivity targets need these correcting mechanisms.

The results reported by the Commission suggest that price caps have worked more or less as intended:

Overall, LEC interstate access rates are currently \$1.5 billion lower than at the start of price caps, despite overall inflation in the economy of 11.6 percent. Of this total, \$373 million is the result of LEC pricing below the cap.⁹

At the same time, all LECs earned more than the target rate of return, and so one cannot conclude that the lower rates reduced the financial viability of the LECs. In fact, the Commission cites a long list of statistics demonstrating that, under price caps, LECs have stepped up their investment in new technology.¹⁰ Given these results, it appears that the "backstop" mechanisms of sharing and low-end adjustment are not needed.

It is also worth considering that the current system might artificially encourage over-investments in LECs at the expense of other firms in the economy. By truncating both the upside returns and the downside risks, sharing and low-end adjustment lower the variance of expected returns from equity investments in LECs. To the extent that investors are risk-averse, they will prefer a stock whose returns show a low variance over a stock whose returns show a high variance, assuming that the two stocks have the same expected return.

⁸Id. at 22.

⁹Id. at 9.

¹⁰Id. at 10.

Thus, the sharing and low-end adjustment mechanisms can give the LECs an artificial advantage in the capital markets over other, nonregulated firms seeking funds.

This result should have been predictable to anyone familiar with rate-of-return regulation. Regulated utilities, such as LECs, have traditionally been regarded as havens for "widows and orphans" because they are less risky (i.e., their returns and share prices have less variation) than other types of investments. Rate-of-return regulation capped profits, but utilities' government-protected monopolies gave them the power to raise prices if they could not cover their cost of capital. Since sharing and low-end adjustment move the price cap system a bit closer toward rate-of-return regulation, it should come as no surprise that they also give the LECs some of the advantages in the capital markets that many utilities enjoy under rate-of-return regulation.

Lower-cost capital is a benefit to the LECs and their customers, but this benefit entails a significant sacrifice. Riskier, unregulated firms receive less capital; as a result, they expand less than they otherwise would, providing fewer goods, services, and job opportunities. This regulation-induced distortion reduces consumer welfare on net, because it alters the allocation of capital resources from what it would be if all markets were competitive. If the Commission truly seeks to "mirror the efficiency incentives found in competitive markets,"¹¹ it should eliminate the sharing and low-end adjustment mechanisms, so that the LECs will compete in the capital markets on an even footing with unregulated firms.

¹¹In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order (Sept. 19, 1990), at 17.

"Transition Issue 1b: What criteria if any should be used for determining when reduced or streamlined regulation for price cap LECs should take effect?"¹²

In antitrust and regulatory proceedings, discussions of workable competition have usually involved contentious discussions about market shares and number of competitors. Rather than enmeshing ourselves in technical debates, CSE Foundation would like to offer three broad principles that the Commission should keep in mind when determining whether an LEC faces competitive discipline:

- 1. In the absence of collusion, even one or two competitors can discipline a dominant firm.**

The Commission will doubtless be assaulted with all manner of conflicting claims about the appropriate number of competitors, and the appropriate market shares, needed to ensure workable competition. These claims may well be accompanied by citations to a theoretical literature on the economics of oligopoly and an empirical literature on the effects of industrial concentration. Neither literature provides a reasonable basis for insisting that large numbers of competitors are necessary to ensure a competitive outcome.

Oligopoly theory

Oligopoly theory purports to provide some insight into the conditions under which small numbers of competitors can successfully collude to raise prices. During the past 40 years, economic theorists have managed to turn models of oligopoly into an art form. In all of the discussions of oligopoly, though, one result stands out: The conclusions theorists draw depend heavily on the assumptions they make. In 1971, economist John McGee noted,

¹²Id. at 40.

"There are many conflicting theories of oligopoly, and predicted behavior depends crucially upon the types of assumptions made."¹³ Economist Sam Peltzman echoed this sentiment recently:

...by and large the current model proliferation in industrial organization is not being driven by any urgent need to understand otherwise inexplicable empirical regularities. It is more nearly being driven by the internal needs of the theoretical enterprise itself: for logical completeness, more intuitively appealing conclusions, and so forth...the totality of the work has led to no convergence even on what the important questions are.¹⁴

Given the inconclusive nature of the theoretical oligopoly literature, it would be unwarranted for the Commission to assume that small numbers of competitors can successfully collude to raise prices.

Concentration and competition

Some empirical economists argue that a market that is more concentrated is inherently less competitive. There exists an extensive statistical literature purporting to prove this claim.¹⁵ If this claim were true, the natural policy conclusion would be that price caps cannot be removed until LECs face numerous competitors.

However, there is equally good evidence that highly concentrated markets are a sign of efficiency, not a cause of monopoly. When one or a few firms develop hard-to-imitate capabilities to provide certain services, the market will be highly concentrated. But the hard-to-imitate capabilities responsible for market concentration also permit the firms to give

¹³J.S. McGee, In Defense of Industrial Concentration (1971).

¹⁴S. Peltzman, "The Handbook of Industrial Organization: A Review Article," Journal of Political Economy (1991), at 201-17.

¹⁵For literature that both supports and contradicts this claim, see the references cited in S. Martin, Industrial Economics (1988), at 158-92.

consumers superior service at lower costs.¹⁶ At best, neither the theory nor the evidence on concentration and firm behavior are conclusive.¹⁷ Therefore, the Commission should avoid adopting standards that require the presence of numerous competitors with large market shares before price caps can be lifted. In the absence of collusion, one or two actual competitors should be sufficient.

2. When barriers to entry are low, even a monopolist faces substantial competitive discipline.

It is now a commonplace in economic theory that potential competition can exercise a powerful restraining influence, even on a firm that has a virtual monopoly. The key issue is not whether there are many competitors, but whether there are high barriers to entry, in the form of "sunk costs" that the new entrant cannot recover if it leaves the industry.¹⁸ When there are no sunk costs, a monopolist has strong incentives to charge competitive prices, because it knows it is vulnerable to rapid, "hit-and-run" entry. Contestability theory is especially relevant in light of the Commission's initiatives to open up the LECs' networks to competing users. As long as potential competitors have access on equal terms to the sunk cost facilities that the LECs own, the LECs have a strong incentive to keep prices at

¹⁶See H. Demsetz, "Industry Structure, Market Rivalry, and Public Policy," J. of Law & Econ. (1973), Y. Brozen, Concentration, Mergers, and Public Policy (1982).

¹⁷J. Carter, "Concentration Change and the Structure-Performance Debate: An Interpretive Essay," Managerial and Decision Econ. (1984) at 204.

¹⁸See Baumol, Panzar, and Willig, Contestable Markets and the Theory of Industry Structure (1982); Bailey, "Contestability and the design of Regulatory and Antitrust Policy," American Economic Review (1981) at 178.

competitive levels. Therefore, for services that involve no sunk costs, or where competitors have access to the LECs' facilities, there is no need to regulate prices.

3. The relevant barrier to entry is not necessarily the cost of building new facilities, but may just be the cost of contracting with customers.

Even when the potential entrant must build its own sunk cost facilities, these sunk costs need not deter entry or insulate the monopolist from competitive pressures. If it is inexpensive for the potential entrant to contract with customers before building any facilities, the potential entrant can establish a customer base before incurring any sunk costs. With a sufficient number of customers already signed up and ready to switch, the entrant can then obtain financing and build the sunk cost facilities.¹⁹ This threat gives the incumbent firm an incentive to keep prices competitive, so that customers do not start looking around for a new supplier.²⁰ Therefore, in any market where the entrant's costs of locating and signing up customers are low, the Commission can safely rely on potential competition to keep rates competitive.

Conclusion

In addition to these specific issues, CSE Foundation would like to offer one broad

¹⁹R. Posner, "The Appropriate Scope of Regulation in the Cable Television Industry," *Bell J. of Econ. and Mgmt. Sci.* (1972) at 98.

²⁰This actually happened in the Southern California natural gas market between 1984 and 1990. Several newly-formed interstate pipeline companies began signing up customers who wanted direct service that would bypass the utilities regulated by the California Public Utilities Commission. Before the new pipelines were even built, the CPUC authorized the utilities to reduce rates to these customers all the way down to variable cost. See Ellig, "Why Do Regulators Regulate? The Case of the Southern California Gas Market," manuscript, George Mason University, 1993.

observation that we hope the Commission will keep in mind as it reviews the LEC experience with price caps. Many actions that LECs could take to enhance efficiency will only pay off over a period of many years. As a result, it is crucial that the Commission demonstrate that it is committed to maintaining a price cap system that will reward superior efficiency over a period longer than that between reviews of the price cap plan. If the Commission adopts major changes in the system every three or four years, it will encourage LECs to adopt that time horizon when considering improvements. Uncertainty about future changes in the price cap plan will inhibit LECs from making efficiency-enhancing investments, unless they will pay off before the next price cap review. The end result would be a system that looks much less like price caps, and much more like rate-of-return regulation with regulatory lag. It would be a shame if the Commission slipped back into the latter system via continual "fine-tuning" of price caps.

The Commission adopted price caps in the hope that superior profit incentives would induce LECs to reduce costs and enhance the quality of service. The results discussed in the Notice of Proposed Rulemaking suggest that price caps are indeed accomplishing that goal.

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